



COMING CLEAN:

DEC 2019

TIME TO OPEN LEBANON'S CHAMBER OF BANKING SECRETS

DAVID WOOD
OLA ABDULLA

HOW LEBANON'S BANKING SECRECY LAWS FACILITATE TAX DODGING AND HARM THE NATIONAL ECONOMY





EXECUTIVE SUMMARY

As Lebanon descends into financial collapse, answers to crucial questions lie behind the shroud of banking secrecy – the strict laws that keep account information confidential. Are powerful citizens stashing illicit wealth inside Lebanese banks? Which account holders should take a progressive “haircut” after profiting from Lebanon’s regulated Ponzi scheme? (See the first instalment in this working paper series, “Extend and Pretend: Lebanon’s Financial House of Cards.”)

Banking secrecy also stands in the way of Lebanon achieving fairer, progressive, and more sustainable public finances, capable of reducing public debt and driving investment. Alarming, estimates suggest that Lebanon recovers less than half of its potential tax revenue. This situation has come about mainly due to the country’s dismally low top tax rate (20%), and the government’s failure to properly enforce and collect progressive taxes, which citizens pay based on what they can afford.

Alongside the government’s lax attitude to tax compliance, banking secrecy helps many Lebanese submit false tax returns, knowing that the Ministry of Finance cannot directly audit their bank accounts. The state has increasingly turned to more regressive taxes (most notoriously, the proposed WhatsApp tax), which disproportionately burden people with lower incomes. The result is widening inequality and social malaise — both evident drivers of the current protest movement.

The only road around banking secrecy goes through the Special Investigation Commission (SIC). An unelected body, the SIC can force banks to reveal

account information about suspected financial crimes. In reality, the SIC was established at the behest of foreign governments – chiefly, the United States – to combat money laundering. True to those origins, the SIC is far more likely to lift banking secrecy for requests from overseas. By contrast, it hardly ever compels banks to hand over information to the Ministry of Finance, Lebanon’s tax authority.



“Due to increased foreign scrutiny, Lebanon has become a less attractive place to covertly stash cash – yet banking secrecy continues to hobble state revenue.”



Due to increased foreign scrutiny, Lebanon has become a less attractive place to covertly stash cash – yet, banking secrecy continues to hobble state revenue. Therefore, the time has come for Lebanon to do away with the practice altogether. But taking down banking secrecy all at once will likely do more harm than good. Secrecy is one of the pillars of Lebanon’s financial sector – removing it immediately would likely result in more capital flight, which is the last thing Lebanon needs at the moment.

Instead, Lebanon should pursue a staged dismantling of the banking secrecy framework. First, confidentiality protections should be lifted for all public officials and civil servants, along with all parties who are awarded state contracts.

Next, the reforms should allow financial investigators to access the accounts of all Lebanese citizens,



facilitating stronger compliance with progressive taxes. Then, non-resident account holders should also lose their rights to banking secrecy.



“The SIC, Lebanon’s sole body empowered to lift banking secrecy for certain suspected financial crimes, has done virtually nothing to make Lebanese taxpayers more accountable.”



For those final steps to take place, Lebanon’s banks will need to stop relying on what – until recently – were easy wins: providing tax haven services and offering progressively higher interest rates. In other words, Lebanese banks must start working harder for their money, and for the Lebanese economy too. Loans should go to high risk (but more productive) sectors, and small businesses that sustain real jobs and client bases for a healthier, more stable financial industry.

BEIRUT CONFIDENTIAL

During the 1950s, Lebanon fully embraced its identity as a free-wheeling, laissez-faire business hub for the West Asia and North Africa region. The Banking Secrecy Law of September 3rd, 1956 fitted neatly with the zeitgeist of promoting business by reducing government interference – it prohibited bank staff from disclosing to authorities each account’s owner, contents, and other related information.¹

The rationale was that customers would view confidentiality as an incentive to deposit funds

in Lebanese banks. In turn, these deposits would encourage further investment and bolster confidence in Lebanese bank credit.

The law did attract an impressive inflow of domestic and foreign capital – total deposits increased by 467% between 1950 and 1961.² This trend continued, even at times of rampant social instability – deposits actually increased during the Lebanese Civil War (1975-1990).³

Conversely, banking secrecy’s harmful consequence is that account holders face barely any scrutiny of their financial dealings by global standards (see Box 1). Under the original law, Lebanese banking staff could only disclose account information if the account holder gives written consent, is declared bankrupt, or becomes a party to legal proceedings involving the bank.⁴

The government seemed to deal with the lack of banking transparency by creating the Special Investigation Commission (SIC) in 2001. But the SIC, Lebanon’s sole body empowered to lift banking secrecy for certain suspected financial crimes, has done virtually nothing to make Lebanese taxpayers more accountable.

BOX 1: Lebanon is ranked 11th in the world on the Financial Secrecy Index 2018, the Tax Justice Network’s (TJN) annual list of banking secrecy jurisdictions. A non-profit organisation, TJN raises awareness about different ways that countries provide financial secrecy. The 2018 rankings place Lebanon – with its powerful confidentiality laws – between well-known tax havens Guernsey (10th) and Panama (12th).



THE SIC: LEBANON'S PAPER TIGER

Established under Law No. 318/2001, the SIC is central to bringing the country's banking sector into line with international standards of financial transparency.⁵ The four-person commission – comprised of the BDL Governor, the Banking Control Commission President, a banking judge, and a professional (nominated by the Banque du Liban (BDL) Governor and appointed by the Council of Ministers)⁶ – is unelected and has deep ties to the banking sector. The original 2001 legislation covered suspected money-laundering offences⁷ – a priority issue for the United States, one of Lebanon's key geostrategic allies.



Ministry of Finance investigators must navigate the labyrinthine formal SIC process, where they have a proportionately low rate of success. Last year, local petitioners brought just seven tax cases before the SIC.



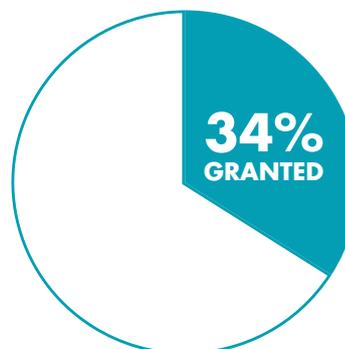
Over time, the SIC's powers have increased to meet international concerns about other alleged offences. Following the 2007-08 global financial crisis, the United States and several European countries started cracking down on tax havens like Lebanon, which had long allowed citizens to hide wealth and avoid paying tax.⁸

In response, Law No. 44/2015 empowered the SIC to lift banking secrecy for suspected tax evasion, terrorism financing, narcotics trading, and other finance-related crimes. Theoretically, the new law created a mechanism for better auditing of both Lebanese and non-Lebanese tax compliance.⁹

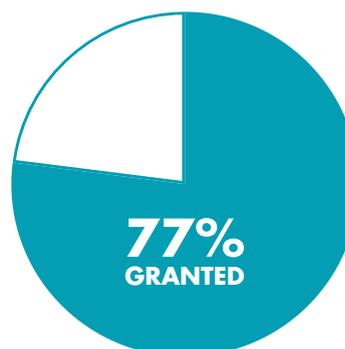
In practice, foreign investigators enjoy far more access to banking information than Lebanese government auditors do. Non-Lebanese authorities benefit from automatic data reporting about Lebanese accounts under various agreements between the Ministry of Finance and other countries. Alternatively, foreign governments can bring proceedings to lift banking secrecy through the SIC – a body favourably disposed to cases originating overseas. On average, the SIC granted 77% of foreign requests access to bank information from 2016-18; the SIC approved just 34% of local petitions during the same period.^{10,11,12} These statistics are consistent with the SIC's self-declared role as "a platform for international cooperation."¹³

REQUESTS GRANTED BY SIC 2016-2018 (AVERAGE)

LOCAL PETITIONS



FOREIGN PETITIONS





The same system has proven woefully inadequate for supporting investigations into evasion of Lebanese taxes. The Income Tax Law requires that all people in Lebanon provide requested information to Ministry of Finance staff conducting income assessments, but makes banking secrecy an exception to that obligation.¹⁴ By regulation, banks are meant to report suspicious tax conduct by Lebanese citizens to the SIC, which can then decide to lift banking secrecy and refer the case to the public prosecutor.

However, banks do not report suspected Lebanese tax cheats as often as they should, according to sources with knowledge of the SIC's inner workings. That means Ministry of Finance investigators must navigate the labyrinthine formal SIC process (see Box 2), where they have a proportionately low rate of success: last year, local petitioners brought just seven tax evasion cases before the SIC.¹⁵

BOX 2: To access banking information of possible tax cheats, government auditors must first apply to the SIC. If the SIC suspects tax evasion, it can then hand over some, or all, of the information to the public prosecutor. Finally, if the prosecutor also believes there are serious grounds, it can use the information to support a tax evasion case (See Diagram).

BANKING SECRECY: YESTERDAY'S HERO

If Lebanon is to ever climb out of its debt hole, the government will need to collect as much tax revenue as reasonably possible; but it cannot do that with banking secrecy in its current form. By preventing financial

accountability, banking secrecy hinders the imposition of a fairer, more progressive tax system – one that would help Lebanon achieve its full, sustainable tax potential. Over the past decade, Lebanon's tax revenue has ranged from 13-16% of national GDP.¹⁶ This proportion is a massive drop from the average of 24% collected in other middle-income countries¹⁷ – an average that Lebanon could exceed.

In fact, an IMF working paper estimates that Lebanon could increase its revenue-to-GDP ratio to as much as 34%,¹⁸ or \$18.2 billion based on last year's figures.¹⁹ That amount is more than triple the \$5.6 billion allocated to improving the electricity sector under the CEDRE Capital Investment Programme.²⁰ In a country where the richest 1% control 45% of the country's wealth,²¹ a steeper progressive income tax range for high earners would prove very lucrative. Of course, that would also mean raising the current top tax rates from a mere 20%.²²

The catch with progressive taxes is that they require a strong government tax authority, capable of piercing the veil of banking secrecy to ensure tax compliance. Denmark, which achieves about 90% of its tax potential, collects progressive taxes with strong and direct investigative powers (see Diagram).

Meanwhile, Lebanon recovers just 49% of its tax potential, not least because Lebanese tax residents have had little to fear from government auditors. Each year, the Ministry of Finance fails to collect around \$3 to \$4 billion in taxes,²³ according to the Institute of International Finance.²⁴ Lebanese companies reportedly avoided paying more than one-third of the total corporate tax amount owed for 2017.²⁵ Different factors contribute to Lebanon's lack of tax



accountability – endemic corruption, the widespread use of fraudulent accounting (sometimes referred to as “double book-keeping”), and the thriving cash economy. Nonetheless, banking secrecy creates a firewall between government auditors and citizens, allowing too many to avoid paying their fair share.

“Banking secrecy creates a firewall between government auditors and citizens, allowing too many to avoid paying their fair share.”

Transparency issues aside, banking secrecy has lost much of its commercial lustre since the global crackdown on tax havens. Already, Lebanese banks are handing over information about foreign account holders from several key countries.

Since 2014, Lebanese banks have taken steps to comply with the Foreign Account Tax Compliance Act (FATCA), a U.S. law that requires foreign banks to provide information to American tax investigators. Lebanese banks now insist that American customers waive their right to secrecy, allowing for compliance with FATCA.

Lebanon also participates in schemes like the OECD’s Automatic Exchange of Information programme (AEOI), under which countries share banking information. These agreements cover nations with large Lebanese expatriate communities like Brazil, France, the United Arab Emirates, Saudi Arabia, the United Kingdom, Canada, and Australia.^{26,27} With these developments, Lebanon has become a less attractive place to covertly

stash cash – yet banking secrecy continues to hobble state revenue.

RECOMMENDATIONS

The current uprising has ushered in a time for bold financial ideas and, perhaps, the political will to implement them. Given this opportunity and the ongoing financial collapse, Lebanon must take steps to improve tax collection – and one of those steps should be removing banking secrecy. Despite this, a sudden, sweeping repeal could cause foreign customers to withdraw their money en masse, heaping more pain on Lebanon’s embattled banks. With the country already reeling from the debt crisis, the most pragmatic solution is an incremental fade out of banking secrecy.

At the same time, multi-staged reforms would give some breathing space for Lebanon’s banking sector to develop new financial services, following years of specialising in high-interest lending and tax haven services.²⁸ Lebanon’s government and central bank could lend support to training courses in more productive work streams, such as microfinancing. What is more, banks could work on bringing the 50% of unbanked Lebanese adults into the banking sector, rather than relying on public debt to drive up profits while public finances buckle under mountains of debt.²⁹

Ideally, the reforms will take place in three acts. Act I should be to lift banking secrecy for all public officials, civil servants, and parties to state contracts. If any future government even aspires to fulfil the demands of protesters, this reform should act retrospectively, allowing the authorities to uncover any illicit wealth held in Lebanese banks. These

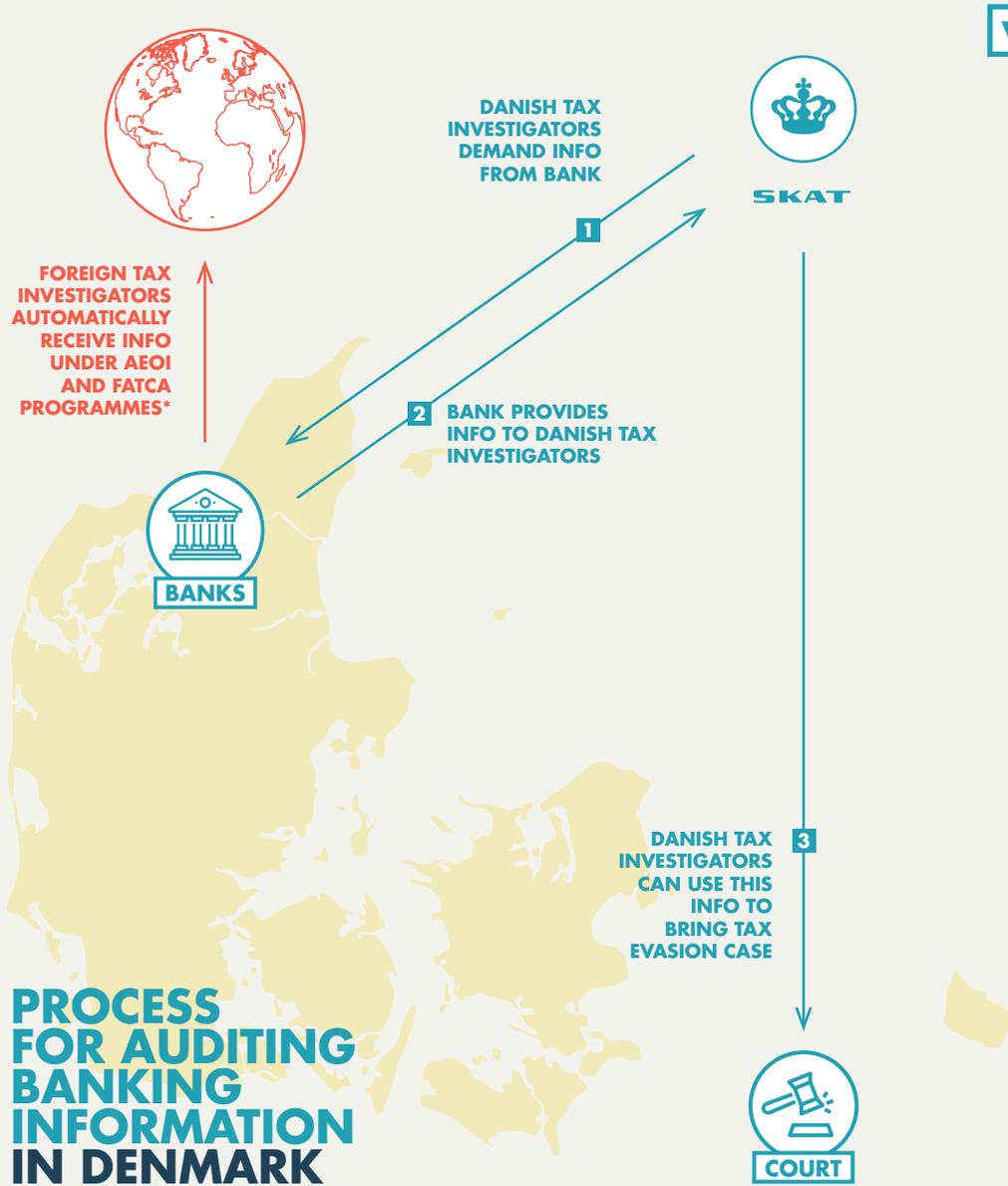


WHO WILL FOOT THE BILL?

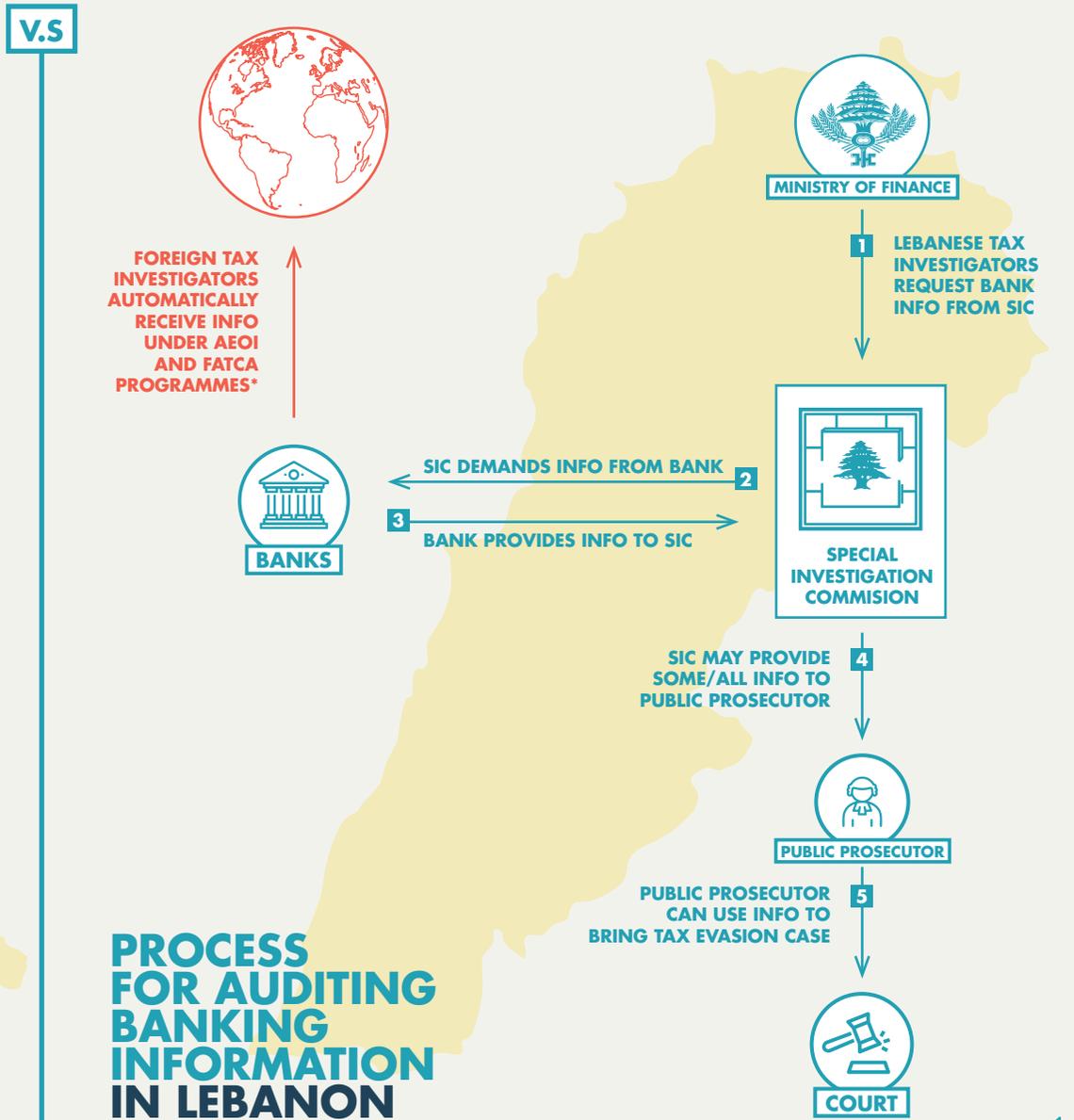
COMING CLEAN: TIME TO OPEN LEBANON'S CHAMBER OF BANKING SECRETS

WORKING PAPER SERIES

HOW LEBANON'S BANKING SECRECY LAWS FACILITATE TAX DODGING AND HARM THE NATIONAL ECONOMY



BANKS PROVIDE INFORMATION TO FOREIGN TAX INVESTIGATORS VIA SKAT



*UNDER THE AEOI PROGRAMME, BANKS PROVIDE INFORMATION TO FOREIGN TAX INVESTIGATORS VIA THE MINISTRY OF FINANCE



powers could also assist investigations into high net-worth individuals who have profited over years from financial engineering and high interest rates, and therefore should receive a progressive ‘haircut.’

Act II must focus on removing banking secrecy protections for all account holders eligible to pay tax in Lebanon. The parliament should amend the Income Tax Law (and any other progressive tax legislation) to empower the Ministry of Finance to access the bank information of Lebanese taxpayers directly. This reform would bring government auditing powers more into line with jurisdictions like Denmark (see Diagram), where tax authorities achieve very high levels of citizen compliance with progressive tax requirements.³⁰



“The future of Lebanon’s offshore banking sector (could be tied) to deposits originating from countries with less political clout – often in the Global South.”



The existing reporting process, under which Lebanese banks can refer suspected tax evasion to the SIC, has not worked. For this reason, Lebanon should eventually do away with the SIC and allow direct cooperation between banks, the authorities, and the judicial system. The government can further support the legitimate exchange of auditing information by partially repealing the Banking Secrecy Law, allowing bank staff to share concerns about Lebanese tax evasion without fear of prosecution. Employees would also need the protection of long-awaited whistle-

blower legislation that still gathers dust in the drawers of Lebanon’s parliament.

Ultimately, in Act III, Lebanon should remove banking secrecy protections for non-resident account holders as well. Powerful OECD countries have already muscled into the Lebanese bank accounts of their citizens. This could tie the future of Lebanon’s offshore banking sector more to deposits originating from countries with less political clout – often located in the Global South.

Lebanon has a moral responsibility not to facilitate tax dodging from any country – rich, poor, or in between. That is because Lebanon’s recovery from the current debt crisis will almost certainly rely on international trust and goodwill.

To restore the nation’s credibility, Lebanon should wean itself off being one of the world’s glorified safety deposit boxes. At last, banking secrecy has blundered into its final act – now Lebanon needs to shunt it offstage.

EDITOR’S NOTES:

The Ministry of Finance did not respond to a request for comment on the reason for bringing so few tax evasion proceedings before the SIC.

This paper is the second edition of the Working Paper Series entitled “WHO WILL FOOT THE BILL,” made possible by the economists, researchers, journalists, and academics who anonymously contributed to this policy paper.



REFERENCES AND ENDNOTES

- 1 Law of September 3, 1956 On Banking Secrecy. Available at: <http://www.bdl.gov.lb/laws/download/2/en>
- 2 Carlos Martinez, Still A Secret, The Business Year, 2017. Available at: <https://www.thebusinessyear.com/lebanon-2017/globalization-could-change-once-attractive-banking-secrecy-laws-in-lebanon/focus>
- 3 Ibid.
- 4 Law of September 3, 1956 On Banking Secrecy.
- 5 Tax Justice Network, "Financial Secrecy Index (Lebanon, 2018)," 3. Available at: <http://www.financialsecrecyindex.com/PDF/Lebanon.pdf>
- 6 Law No. 318 of April 20, 2001 on Fighting Money Laundering. Available at: http://www.bccl.gov.lb/pdf_files/laws-pdf-files/law318.pdf
- 7 Ibid.
- 8 Nicholas Shaxson, "Tackling Tax Havens," Finance & Development, September 2019. Available at: <https://www.imf.org/external/pubs/ft/fandd/2019/09/pdf/tackling-global-tax-havens-shaxson.pdf>
- 9 Law No. 44 of November 24, 2015 on Fighting Money Laundering and Terrorist Financing. Available at: <https://sic.gov.lb/sites/default/files/laws-regulations/Law%2044%20En.pdf>
- 10 Special Investigation Commission, "Annual Report, 2016." Available at: <https://www.sic.gov.lb/sites/default/files/publications/3335%20-%20SIC%20Annual%20Report%202016%20ENGLISH.pdf>
- 11 Special Investigation Commission, "Annual Report, 2017." Available at: <https://www.sic.gov.lb/sites/default/files/publications/3500%20-%20SIC%20Annual%20Report%202017%20ENGLISH%20ALL.pdf>
- 12 Special Investigation Commission, "Annual Report, 2018." Available at: <https://sic.gov.lb/sites/default/files/publications/SIC%20AR%202018%20En%20v0.pdf>
- 13 Ibid, 13.
- 14 Income Tax Law - Legislative Decree 144 of 12/6/1959, Article 103. Available at: <http://www.finance.gov.lb/en-us/Taxation/LRT/Documents/%D9%82%D8%A7%D9%86%D9%88%D9%86%20%D8%B6%D8%B1%D9%8A%D8%A8%D8%A9%20%D8%A7%D9%84%D8%AF%D8%AE%D9%84.pdf>
- 15 Special Investigation Commission, "Annual Report, 2018."
- 16 Ministry of Finance, Public Finance Annual Review, 2017. Available at: <http://www.finance.gov.lb/en-us/Finance/Rep-Pub/DRI-MOF/PFR/Public%20Finance%20Monitor/Annual%202017-%20Final%20version.pdf>
- 17 Ricardo Fenochietto & Carola Pessino, "IMF Working Paper: Understanding Countries' Tax Effort," November 2013. Available at: <https://www.imf.org/external/pubs/ft/wp/2013/wp13244.pdf>
- 18 Ibid.
- 19 World Bank, "Lebanon's Economic Outlook," October 2018. Available at: <http://pubdocs.worldbank.org/en/756401538076843074/mpo-am18-lebanon-lbn-2.pdf>
- 20 Government of Lebanon, "Capital Investment Programme – CEDRE," April 6, 2018. Available at: <http://www.cdr.gov.lb/study/cedre/cedrelist.pdf>
- 21 Sami Halabi and Samir Kheir, "A New Financial Deal for Lebanon," Triangle, December 2018. Available at: http://www.thinktriangle.net/wp-content/uploads/2018/12/20181217_A_New_Deal_For_Lebanon_300dpi.pdf
- 22 Invest in Lebanon's Business Support Unit, "You're Your Taxes," November 2017. Available at: <https://investinlebanon.gov.lb/Content/uploads/SideBlock/171220035630093~BSU.%20KNOW%20YOUR%20TAXES.pdf>



- 23 The figure varies due to the different methodologies used to estimate the extent of tax evasion in a country. Since each of the methodologies of the different sources cannot be directly compared and only constitute rough estimates, the range needs to be read with care. But it does give a sense of the problem's magnitude: Mounir Mahmalat & Sami Atallah, *Why Does Lebanon Need CEDRE? How Fiscal Mismanagement and Low Taxation on Wealth Necessitate International Assistance*, October 2018. Available at: https://lcp-lebanon.org/publications/1539847190-policy_brief_34_eng.pdf
- 24 Institute of International Finance, "Lebanon: Wake-Up Call," Sep 2019. Available at: <https://www.iif.com/Portals/0/Files/content/Research/Final%20September%20202019%20IIF%20Lebanon%20Report.pdf>
- 25 Mounir Mahmalat & Sami Atallah, "Why Does Lebanon Need CEDRE? How Fiscal Mismanagement and Low Taxation on Wealth Necessitate International Assistance," October 2018.
- 26 OECD, "Jurisdictions Participating in the Convention on Mutual Administrative Assistance in Tax Matters Status," October 2019. Available at: https://www.oecd.org/tax/exchange-of-tax-information/Status_of_convention.pdf
- 27 Françoise De Bel-Air, "Migration Profile: Lebanon," Migration Policy Centre, May 2017. Available at: https://cadmus.eui.eu/bitstream/handle/1814/46504/RSCAS_PB_2017_12_MPC.pdf?sequence=1
- 28 Tax Justice Network, "Financial Secrecy Index, Country Report – Lebanon (2018)." Available at: <http://www.financialsecrecyindex.com/PDF/Lebanon.pdf>
- 29 Lauren Clark and Garbis Iradian, "Lebanon: Raising Financial Inclusion, Institute of International Finance," September 23, 2016. Available at: <http://www.databank.com.lb/docs/Raising%20Financial%20Inclusion-IIF-2016.pdf>
- 30 Henrik Jacobsen Kleven et al., "Unwilling or Unable to Cheat? Evidence from a Tax Audit Experiment in Denmark," *Econometrica* 79(3) (May, 2011), 651-692. Available at: <https://eml.berkeley.edu/~saez/kleven-knudsen-kreiner-pedersen-saezEMA11taxaudit.pdf>.